When signed please return to PMS/PA, Room 1818 N.S.



MEMORANDUM

TO: M - Mr. Macomber

FROM: M/DG - William O. Hall

SUBJECT: Foreign Service Retirement Policy--INFORMATION MEMORANDUM

OMB's reply to the Department's letter of June 4, 1971 proposing legislation to equate Foreign Service retirement benefits with comparable Civil Service benefits and for other purposes is at Tab A for your information.

OMB, although not disputing our view that present financing arrangements are adequate to pay all Foreign Service retirement benefits as they become due, asserts that if the Foreign Service retirement system is to be continued, its full normal cost must be met by increasing both the Government and the employee contribution rates by a total of roughly $10 million annually. OMB states that the only alternative to such increased funding is the abolishment of the Foreign Service retirement system and its incorporation into the Civil Service retirement system with preservation of certain key benefits.

In our view, OMB has stated the alternatives in a most unrealistic and unfair way in order to force us to accept the consolidation approach which they favor. An analysis of the superficial nature of the policy OMB professes to be following is at Tab B.

Although the OMB position is unfairly stated, their view that the Foreign Service normal cost must be fully paid is strongly held. It is supported by a recent change in thinking at Treasury of which OMB may not yet be aware.

The Treasury Actuary has tentatively concluded that it is unfair for interest to be paid on the Foreign Service unfunded liability if the full normal cost is not also paid. Failure to pay the full normal cost means that this short fall is added to the unfunded liability. Thus payment of interest on the ever increasing unfunded liability makes up, at least in part, for the failure to pay normal cost. The concept of paying interest on the unfunded liability was developed as a device to stabilize and fund existing retirement debt (unfunded

liability). It was not intended to finance retirement benefits currently being earned (normal cost). Thus, in this view, a windfall benefit is being reaped by the Foreign Service retirement system because of the failure to pay its full normal cost.

The combined views of Treasury and OMB will probably force the Department either to give up an independent Foreign Service retirement system or to seek funds to fully pay its normal cost.

## Additional Funding Alternative

Assuming OMB can be prevailed upon to accept a reasonable employee contribution rate, we lean to the view that we should adopt the additional funding alternative rather than consolidation. At this point, we see no long term disadvantage to the Department's seeking additional appropriations for the Foreign Service retirement fund. The basic problem would be to explain to the Congress the reason for the relatively high cost of the Foreign Service retirement system. Since this cost results primarily from the career nature of the Foreign Service, its low turnover etc., and not from superior benefits, it should be possible to make a convincing case for additional funds. Once the case is made, an annual appropriation to the Foreign Service retirement fund of the residual normal cost should become routine. We might seek a permanent indefinite appropriation for this purpose.

## Consolidation Alternative

We foresee possible serious difficulty in achieving the consolidation alternative on acceptable terms. Consolidation would require an amendment of the Civil Service retirement system which is under the jurisdiction of the Post Office and Civil Service Committees of the Congress. Employee unions have demonstrated considerable influence with these Committees and have always strongly opposed any reduction in mandatory retirement age. We think there might be difficulty in getting the Civil Service Committees to approve a special provision of the Civil Service retirement law to provide for mandatory retirement at age 60 for most of its new Foreign Service participants. There could also be difficulty over provisions for immediate annuities for those selected-out from class 3 and above with no minimum age or service requirements.

CIA Retirement System

CIA has received informal indications that both OMB and Treasury intend to apply the same principles to the CIA retirement system as are applied to the Foreign Service retirement system. The CIA system is comparable in benefits and expense to the Foreign Service system. CIA is uncertain of its response at this point and is seeking our views.

Continued Analysis

We are continuing our analysis of this problem and seeking views from A, USIA and others. We hope to have a firm recommendation and reply to OMB ready for your approval in two weeks.

Attachments:

A - Letter from OMB
B - Analysis of OMB's policy

Clearances:
DG/PER - Mr. Noel, Acting
PER/PMS - Miss Olmsted

PMS/PA:RBHull:cal:3/7/72:x21273

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

FEB 22 1972

Honorable William P. Rogers
Secretary of State
Washington, D.C. 20520

Attention: Mrs. Edith Waskewich
Room 7247A

Dear Mr. Secretary:

This is in response to Mr. Abshire's request of June 4, 1971 for advice on amendments to the Foreign Service Retirement system which the Department of State wishes to present to the Congress.

We have only one major problem with the proposed changes in benefits: The increase in maximum service credit from 35 to 40 years would be inconsistent with the objective of a young, vigorous Foreign Service because it would encourage older employees to defer their retirement. We request that you reconsider this point.

Underlying the whole question of Foreign Service retirement, however, is the question of the financing and administration of the system. The main problem consists in the disparity between the normal cost of Foreign Service retirement benefits--27.4 percent of payroll--and the total Government and employee contribution of 14 percent. This disparity makes it impossible to approve any new benefits and imperative that a more satisfactory arrangement be found for financing present benefits.

We cannot agree with the position implicit in Mr. Abshire's letter that present financing arrangements for the Foreign Service Retirement Fund eliminate the need to cover normal costs. Such a position is contrary to the policy for contributory civilian employee retirement programs emerging from studies over the last 20 years and embodied in legislation in recent years. Those policies, with which we believe the financing of Foreign Service retirement should be consistent, are--

a. The normal costs of each independent retirement system should be fully covered by Government and employee contributions.

b. The normal costs should be shared by--
   -- the Government bearing the cost of provisions primarily benefiting management; and

   -- the Government and employees dividing equally the cost of provisions benefiting employees.

c. Separate retirement systems are justified only by unique personnel management requirements. Lesser differences should be accommodated by modifications within the Civil Service system.

Pursuant to these policies, we see two basic alternatives for reforming the financing of Foreign Service retirement:

1. As a separate system. This would entail approximately doubling the total Government/employee contribution from 14 to 27.4 percent. This would not require that the total contribution be shared equally by the Government and the employee as under the Civil Service system, since the early retirement provisions of the Foreign Service system were adopted primarily to meet the needs of management. The employee share would not, however, necessarily remain at 7 percent, the same as for the Civil Service, since each separate system should be costed separately. There is ample precedent for a higher Foreign Service employee contribution: The Foreign Service rate was set at twice the Civil Service rate in 1924 because of more generous benefits and continued higher until 1942. The sharing of contributions would be determined by an analysis of the cost of those features that benefit management and those that benefit the employee.

2. As part of the Civil Service system. This would make special provision for the Foreign Service, as has already been done for certain law enforcement employees within the Civil Service system. Because Foreign Service employees would be an integral part of the Civil Service retirement system, they would pay the same contributions as all members of the system. In bringing the Foreign Service under the Civil Service system, we would want to review the special Foreign Service provisions that would continue, but we would not expect to challenge the

basic features now in effect such as voluntary retirement at 50 with 20 years' service, mandatory retirement at 60, and the 2 percent multiplier for each year of service. Certain minor advantages of the Foreign Service might be lost as the result of this review where Civil Service practice appeared more satisfactory from a Government-wide perspective, but this would be offset by the extension to the Foreign Service of Civil Service benefits it now lacks, as the Department has requested.

Our preference is for the second alternative, because a single comprehensive--but not in all respects uniform--system would help to assure equity, eliminate unnecessary discrepancies, and simplify administration. We are willing to consider either alternative, however, as long as the basic principles set forth above are observed.

If the Department favors the first alternative, we would need to review its recommendations and supporting analysis of how the total normal cost should be divided between Government and employee contributions. If it prefers the second alternative, we will need its recommendations as to the modifications in the Civil Service system which would be necessary to meet Foreign Service needs, including the special management authorities of the Secretary of State.

Sincerely,

Wilfred H. Rommel

Wilfred H. Rommel
Assistant Director for
Legislative Reference

Tab B

Analysis of OMB Retirement Policy

OMB states that the employees in each independent retirement system should share its normal cost with the Government. This policy fails to recognize that normal cost is an actuarial concept used to measure certain but not all retirement system costs. It bears no direct relationship to benefits received by retirees. Two systems could have identical benefits but totally different normal costs. Accordingly, it does not follow, as OMB's letter implies, that if an employee pays one half the normal cost, he is paying his fair share of retirement costs.

It is a happy coincidence that the equal sharing of the Civil Service normal cost between employees and the Government produces an acceptable employee contribution rate. Therefore, this policy for the Civil Service is acceptable and it serves the very useful purpose of keeping employee demands for new benefits responsible. The latter is the fundamental reason for this policy, not its inherent fairness.

The arbitrary basis for this policy was shown by remarks of John Macy at a 1965 meeting of the Cabinet Committee then studying retirement policy. A proposal was under discussion to raise the normal cost significantly by redefinition in order to include the retirement costs of future general pay raises. Macy opposed the proposal on the ground that it would produce an unacceptably high employee contribution rate. The Committee accepted this view and retained the present definition of normal cost in order that 50% of normal cost would produce an acceptable employee contribution rate.

A current incident can also be cited to demonstrate the same point. The Civil Service normal cost has recently been reduced by 1%, from 14% to 13%, because of the adoption of a higher interest rate to project future interest income to their fund. Under the OMB policy now in force for the Civil Service system, one would expect the employee contribution rate to drop or benefits to be increased. However, a recent news story quotes the Administration as planning to oppose both an increase in benefits and a reduction in the employee contribution rate on the ground that the current employee contribution does not begin to cover one half of <u>actual</u> retirement

costs. We believe this subject is now under debate within OMB. Unless the news article was totally erroneous, it demonstrates that the policy recited to us has something less than universal acceptance.

The fallacy in the OMB letter is the attempt to impute a universality to a policy of convenience that up to now has been useful for the Civil Service system but not other systems. OMB proposes to extend this policy to the Foreign Service without sufficient modification to make it acceptable. They are proposing to do this at a time when sufficient funds are already being earmarked for retirement purposes so that the Actuary believes that all benefits can be met when due--a cardinal concept of retirement policy that OMB fails to mention.

In previous correspondence, OMB has estimated that application of their policy to the Foreign Service would produce an employee contribution rate of between 9 and 11 percent. In view of the 7 percent rate in effect in all other systems in the Executive Branch, and with others having a variety of benefits equal to and, in the case of the Secret Service, exceeding Foreign Service benefits, we think employees would view a rate substantially above 7 percent as unacceptable. Capable employees might refuse to join the Foreign Service. We think it is unrealistic for OMB to insist on such a policy and hope that they and the Congress would agree to a policy of maintaining the Foreign Service contribution rate identical to the Civil Service rate if the Department funds the balance of the normal cost.

The policy which has evolved and which has been followed during the last dozen years is that the employee contribution rates in all Executive Branch systems should be maintained at the Civil Service rate and the Civil Service system set the standard for benefits. We believe this to be a fair and practical policy and urge its continuation.

OMB states another element of their policy as follows: "Separate retirement systems are justified only by unique personnel management requirements. Lesser differences should be accommodated by modifications within the Civil Service system." The last policy statement on this subject of which we are aware was contained in the Cabinet Committee report of 1966. This report, signed by the then Director of the Bureau of the Budget, stated that

there were three major Federal retirement systems: military, Civil Service and Foreign Service. It enumerated a number of smaller systems and said that consideration should be given to merging these with the Civil Service system. The above quoted element of OMB's policy appears to be taken out of context from this section of the last major study of Federal retirement systems.

| TRANSMITTAL SLIP | DATE 27 March 1972 |
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TO: Mr. Briggs

| ROOM NO. | BUILDING |
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REMARKS:

Attached concerns funding of CIARDS and Finance Division has suggested that you receive it also in anticipation of developments.

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FROM: [redacted] OLC

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**Remarks:** Attached concerning retirement funding is being sent to Messrs. Fisher, Yale [redacted] with a request that it be treated in accordance with the needs of source who passed it on to me for my "personal information" and with an injunction not to discuss the matter widely.

I believe that somewhere down the pike it would be mutually beneficial to State and ourselves to sit down and determine the pros and cons of the various options available since it will be difficult for either system to avoid the application of whatever principles are applied to the other.

As things stand now with OMB, we will be hearing from them once they have resolved the situation with State. I don't see any advantage in initiating earlier action with OMB. However, I do believe that the initiation of a position paper on this subject within the Agency is in order now.

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REMARKS OR ADDITIONAL ROUTING

Attached for your personal information is a draft report on the retirement question. Please don't discuss this very widely before calling me.

Bob

| FROM: (Name and Org. Symbol) | ROOM NO. & BLDG. | PHONE NO. |
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| Robert B. Hull, Jr. PMS/PA | 1818 N.S. | [redacted] |



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